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Tax Considerations Applicable to a Buy-Out of a Pass-Through Entity

In the face of rising public market valuations in recent years, private equity sponsors have turned to privately-held targets, many of which operate in pass-through form for tax purposes (typically as partnerships or limited liability companies). What these tax structures have in common is that the profits of each enterprise generally avoid entity-level taxes and are taxed a single time, at the owner level, making them ideal for businesses owned by a single founder, a small group of partners, or a family. The complexities of these structures may not be the optimal choice for a private equity buyer, however, as discussed in more detail below.

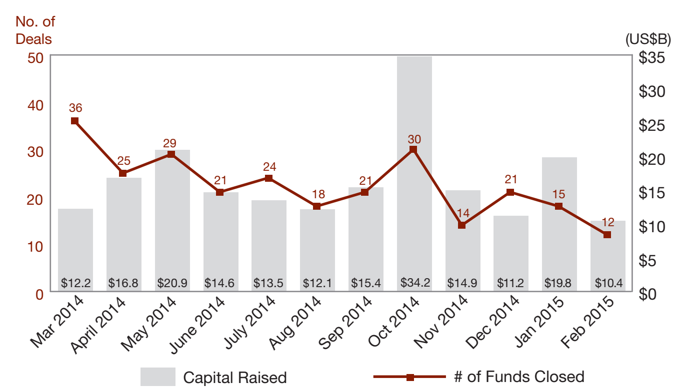
Basis Step-Up When Acquiring a Pass-Through Entity

Regardless of the manner in which a sponsor intends to own the target, finding a target in pass-through form usually benefits the buyer to some extent. Unlike sellers of a C corporation, who generally resist taxable asset sales because they would typically result in the incurrence of two levels of tax, the owners of a pass-through entity are subject to a single level of tax and therefore often will be willing and able to structure a transaction as an asset sale for tax purposes. As a result, if the assets of the target have a value in excess of their aggregate tax basis, the buyer will receive a "basis step-up" in the assets, which may be amortized or depreciated to offset future taxable income. For some tangible assets, this benefit can be claimed over a time period that corresponds to the typical private equity holding period, while for intangible assets this benefit is generally spread over fifteen years. Of course, to make full use of this benefit, the business must generate taxable income, even after the substantial interest deductions that generally accompany private equity buyouts. If a pass-through entity operates at a tax loss, restrictions apply to the use of losses by owners.

Comparison of Pass-Through and Corporate Acquisition Structures

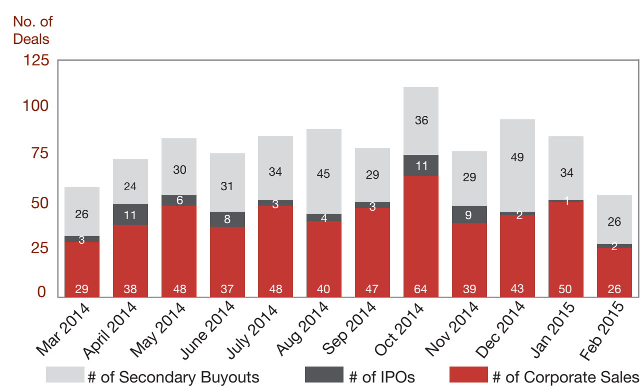
At first glance, the opportunity to own a business in a pass-through structure presents the obvious additional benefit of a single level of tax. Consider the acquisition of a limited liability company worth $300, using $200 of debt and $100 of equity. Assume that the company is owned by the founders of the business and, as is quite common in such fact patterns, has no tax basis other than the basis to be achieved in the current transaction, which is allocated entirely to intangible assets amortizable over fifteen years.

U.S. Private Equity Fundraising



Source: Pitchbook

U.S. Sponsor-Backed Exits By Number



Source: Pitchbook

If the company is acquired in a pass-through structure:

- The company will allocate $15 of taxable income to its owners.
- The owners will pay $6 of tax (assuming a 40% tax rate).
- This allocation of income will generate a basis step-up for the owners in their equity interests in the company of $15.
- The owners may cause the company to distribute $6 of this $15 to help the owners pay their taxes attributable to the income of the company and retain $9 after tax.
- If the owners later sold the company on a debt-free basis for $309, they would owe no additional tax.

If the company is acquired in a 100% corporate blocker structure:

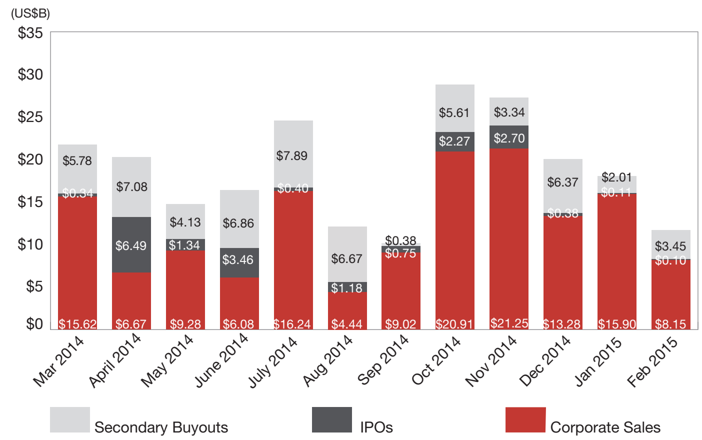
- The corporation will generate $15 of taxable income.
- The corporation will pay corporate income tax of $6.
- The owners of the corporation will not receive a basis step-up in the corporate stock they own by reason of the corporation's after-tax undistributed earnings as they did in the flow-through case.
- If the company distributes $9, assuming a 25% tax rate on dividends, the owners will pay $2.25 of tax and retain $6.75 after tax.
- Alternatively, if the owners left the $9 in the business and later sold the company on a debt-free basis for $309, assuming a 25% tax on capital gains, they would owe an additional $2.25 of tax and retain $6.75 after tax.

Thus, in this case, the use of a pass-through structure saves $2.25. However, this example assumes that all investors are subject to U.S. tax on capital gains and dividends with respect to corporate stock. In reality, U.S. tax-exempt investors, sovereign wealth funds, and other non-U.S. investors may be exempt from some or all of these taxes, which would reduce the burden of the second layer of tax.

Investor Tax Considerations in a Pass-Through Structure

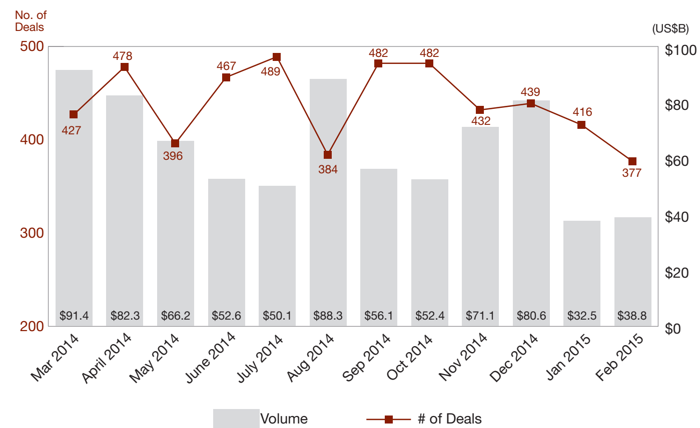
Additionally, behind the benefit of a single layer of tax are the potential negative consequences of passing through operating income to the partners of a private equity fund. U.S. tax rules generally require U.S. business activity to be subject to at least one level of tax at ordinary income rates. As a result, even non-governmental tax-exempt owners of a pass-through entity (such as charities, foundations, and pension plans) will generally be subject to tax on the income generated by an operating pass-through, which is treated as "unrelated business taxable income." For some tax-exempt entities, unrelated business taxable income transcends economics, and could cause the entity to lose its tax-exempt status. Similarly, non-U.S. investors, even if not otherwise subject to U.S. tax, are generally required to file U.S. tax returns and pay U.S. income taxes at ordinary rates on their "effectively connected income", which includes income earned through a pass-through that is engaged in a U.S. trade or business. Finally, foreign governments and sovereign wealth funds (known as "Section 892

U.S. Sponsor-Backed Exits By Dollar Volume



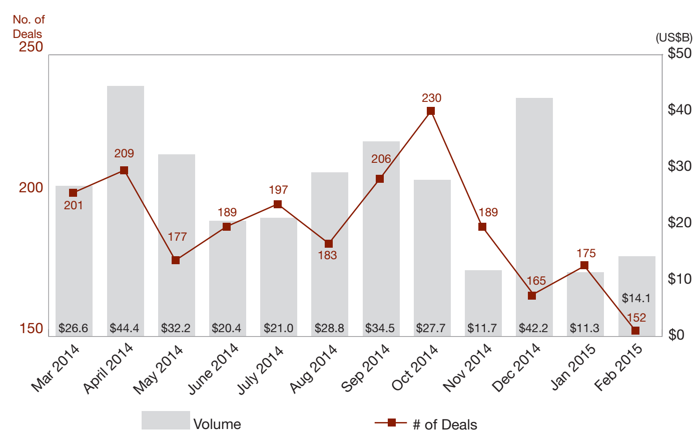
Source: Pitchbook

Global Sponsor-Related M&A Activity



Source: Dealogic

U.S. Sponsor-Related M&A Activity



Source: Dealogic

Investors") are eligible for an exemption from U.S. tax on investment income only if they earn no "commercial activities income", which includes effectively connected income. Many of these investors would prefer to bear the indirect economic burden of corporate taxation than own a direct interest in an operating pass-through. Because of the prevalence and influence of tax-exempt and non-U.S. investors in private equity funds, it is unlikely that a fund will be able to hold an operating business entirely in pass-through form. Another factor that may discourage a fund from owning a direct interest in an operating flow-through is the burden of state tax compliance. Owners of an interest in an operating flow-through are generally deemed to have nexus with every state in which the company has nexus. The state tax compliance obligations that flow from this can be substantial and costly in a nationwide business.

Basis Step-Up on Sale of a Pass-Through Entity

Notwithstanding the foregoing words of caution, assuming that a private equity sponsor maintains a significant percentage of its ownership of the target in pass-through form, a further meaningful benefit may arise on sale. Just as the sponsor received a basis step-up when it purchased the pass-through target, the sponsor can pass on at least a partial basis step-up to the next buyer of the business. Depending on the identity of the next buyer and their plans for the company, this basis step-up may be more or less valuable. For example, a buyer that already has net operating losses or that intends to operate the company with substantial leverage may not value additional tax basis highly. On the other hand, a strategic buyer that is a regular corporate taxpayer and lacks other tax attributes to shelter its earnings may value the future earnings and cash flow benefit of the basis step-up nearly as highly as if it were generated by operations. Additionally, some buyers may value the opportunity to keep the business in pass-through form, although financial buyers may require corporate blockers for certain classes of investors, and strategic buyers may already operate in corporate form.

Conclusion

Taking these factors together, a pass-through target clearly presents additional flexibility and opportunities for beneficial tax planning, but also offers additional risks and complexities. While a pass-through structure can be more efficient on the right facts, it does not always save cash taxes and may lead to greater tax complexity or cause investor-specific tax issues. In considering the acquisition of a pass-through entity, a private equity buyer should analyze the potential tax basis consequences and the potential benefits of the single layer of tax as part of its overall financial model. The potential tax savings and the ability to sell a basis step-up to the next buyer are well worth grappling with the complexity of the pass-through tax rules.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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